



GOVERNOR'S TRANSACTION PRIVILEGE TAX SIMPLIFICATION TASK FORCE CONTRACTING WORKING GROUP MINUTES

Tuesday, August 21, 2012

1:30 PM

1820 W. Washington, St. #200, Conference Room 101
Phoenix, Arizona 85007

A public meeting of the Transaction Privilege Tax Simplification Task Force was convened on August 21, 2012 in Conference Room 101, 1820 West Washington, St. #200, Phoenix, Arizona 85007. Notice having been duly given. Present and absent were the following members of the Task Force.

Members Present

Michael Hunter (Chair)
John Olsen
Miguel Teposte
Tom Belshe
Linda Stanfield

Steve Barela
Kevin McCarthy
Vince Perez
Representative Rick Gray

Members Absent

Senator John McComish
Keely Hitt

Lynne Herndon

Staff Present

Lorna Romero, Governor's Office
Lindsay Scornavacco, Governor's Office

1) Call to Order

Michael Hunter called the meeting to order at 1:31 p.m.

2) Welcome & Introduction of Working Group Chair

Mr. Hunter introduced Craig McPike as the working group chairman for the Contracting Working Group.

3) Overview and Scope of Working Group

Mr. McPike opened that tax law affecting contractors is very complex and that he hopes this group can determine the issues and help improve the system for everyone's benefit. He continued that a lot of time and skill is required to comply with the tax law, which is challenging because a lot of contractors are small businesses. Mr. McPike pointed out that licensing is also a concern and that H.B. 2466 may help to ease the process. He continued that the revenue sharing formula is particularly complex and that one of the roadblocks to improvement of the system is how money is shared among jurisdictions.

a) Working Group Discussion and Public Comment

No comments were made.

4) Tax on Contracting – Overview of Current Tax Scheme

Mr. McPike clarified that the tax structure for contracting taxes the gross proceeds of sale and that it is the business activity that is subject to tax and not that there is a tax on the person that needs the services. Mr. McPike explained that the tax liability is on the actual business conducting activities but that contractors can pass the economic burden on to customers. The courts have ruled it acceptable to pass on the burden contractually, which is how revenues are generated from federal contracts.

Kevin McCarthy interjected that this issue extends across TPT and is not limited to contracting. He explained that transitioning to a point of sale will not undo the process of extracting money from the federal government.

a) Presentation: Department of Revenue

Christie Comanita from the Department of Revenue gave a presentation on the overview of the current tax scheme, specifically the prime contracting classification under Title 42, from the view of the Department.

Mr. McPike asked if this presentation was referring to homes being built as opposed to buildings in the service industry.

Ms. Comanita responded that construction is limited to commercial or residential homebuilding.

Mr. McPike announced that all of the presentation materials can be found online on the TPT website.

b) Presentation: Arizona League of Cities and Towns

Lee Grafstrom from the Arizona League of Cities and Towns gave a presentation on the current tax scheme from the view of the Arizona League of Cities and Towns.

Mr. Hunter clarified that Mr. Grafstrom's presentation was describing the Model City Tax Code without delving into variations, options and inconsistencies between the 18 non-program cities.

Mr. Grafstrom stated that he was speaking at a 50,000 foot level.

Mr. Hunter asked if different cities like Chandler, Phoenix and Mesa may look at the value arm differently.

Mr. Grafstrom stated that was not typically the case. When trying to find the value of the business piece, variations from city to city will not be found.

Mr. McPike asked Mr. Grafstrom to describe what happens in a situation when someone builds a property on their own land intending it for personal use but then decides to sell it after construction.

Mr. Grafstrom answered that if someone builds a property for personal use, never uses it and wants to sell it within 24 months of construction, then that person becomes a speculative builder. He

continued that the definition is a function of transaction and not of intent. If someone meets the definition of a speculative builder, then that is the category in which he or she is taxed.

Mr. McCarthy asked why this discussion was being brought up under the banner of prime contracting.

Mr. Grafstrom answered that cities do not have a prime contracting classification. There is construction contracting, speculative builder and owner builder which were in place in various cities prior to the adoption of the code. He continued that nobody falls under the owner builder category anymore because contractors are creating the contracting and marketing arm structure to avoid it. Section 417 applies to someone that was subject to speculative builder but failed to sell within the time period. After the 24th month it is switched to owner builder and the individual has to pay the taxes that should have been paid. This turns it from speculative builder to prime contracting.

Tom Johnson from the Department of Revenue clarified that this is commercial and not residential.

Mr. Grafstrom agreed, stating residential does not have a 24 month time period.

Miguel Teposte asked under owner builder if the state taxability of improvements falls on the prime contractor.

Ms. Comanita said that was correct but that the tax base is limited to the value of improvements. She continued that the owner builder statute is considered null and void in that case.

c) Working Group Discussion and Public Comment

Mark Minter from the Arizona Builders Alliance rose to thank the Arizona League of Cities and Towns for hosting the event and to thank the Task Force for coming together. He continued that he would like this effort to result in increased predictability for contractors, stating that prime contractors have to understand what is incorporated into a bid to be able to relay it to owners. Mr. Minter continued with the following comments:

- Moving toward a point of sale.
- Clarifying that engineering services are not subject to tax.
- Exploring service contracts and subcontractors getting taxed when they are hired for nothing but labor.
- Explaining the issue of contractors' status unintentionally changing in the middle of a project, subjecting subcontractors to taxes as prime contractors unexpectedly years later.
- Strengthening the hospital exemption.

Mr. Hunter commented that many of the comments made by Mr. Minter demonstrate he represents Arizona business people. He continued that contracts are made with out of state businesses that bid on contracts not knowing what Arizona business is like. There are times when Arizona business may be at a competitive disadvantage because out-of-state businesses may not be on the radar screen for tax liability the way in-state businesses are.

Mark Minter from the Arizona Builders Alliance responded that contractors may follow an owner to Arizona, stop in and do a project and go home. They do not need a contractor's license to work on a federal military base so they do not have to register with the Department of Revenue. They do the

project and leave. He continued that this puts the contractor working outside the base at a competitive disadvantage.

Ms. Comanita responded that these contractors are not required to pay the bond but are required to pay TPT.

Mark Minter from the Arizona Builders Alliance replied that nobody forces these out of state contractors to go to the Department of Revenue to get a license.

Mr. Grafstrom answered that they must in order to pull a building permit.

Mark Minter from the Arizona Builders Association responded that this was not the case on a military base.

Mr. McPike commented that he believes the point of the discussion is that out of state contractors do not include taxes into their bids because they do not understand the system in Arizona. They then get the contracts they are bidding for because their estimate is lower.

Mr. Hunter commented that a lot of what is being discussed with regard to reforms is if a transaction is taxable or not. This discussion is about changes to the tax base. Mr. Hunter reiterated that the Task Force is going to have to deal with certain provisions in Prop 204. He reminded the Task Force that a lot of the conversations being had at these meetings and potential clarifications may go through the Legislature and be a change to the state tax base. The Task Force has to look to see to what extent Prop 204 may tie the Legislature's hands.

Tom Belshe asked if large residential materials are mostly purchased from in-state or out-of-state businesses.

Spencer Kamps from the Home Builders Association of Central Arizona responded that he has not looked at the issue closely, but from anecdotal experience he suggested many do not make major purchases out of the state. The projects are generally locally driven.

Representative Gray gave the example that his small company would buy in bulk in state.

Mr. Belshe commented that he would like more information on this because he had heard anecdotally that most of the materials are purchased out of state. Cities and towns would have to adopt a use tax to capture those sales.

Representative Gray commented that he likes the idea of switching to point of sale. He continued that the numbers may not line up, but it would be fairer.

Mr. Hunter commented that the mismatch in numbers may be offset by gaining missed opportunities.

Mr. McPike mentioned that leading up to this meeting he had met with a lot of contractors that want to do the right thing but because of the complexity have gone the easier route and have not paid the proper taxes. He suggested there may be revenues that could be realized.

Mr. McCarthy questioned why a homebuilder would purchase materials out of state if the Arizona exemption on materials would not be valid?

Mr. McPike interjected that this meeting may not be the best arena to discuss legal complexities.

Barb Dickerson from Deloitte Tax LLP responded that orders placed out of state are typically exempt. California, for example, has quirky laws on the issue and it is difficult to make a general statement of what is exempted because it depends on how the transaction comes down in the state where the purchase is made. She continued that there are use tax credits for sales tax paid in other states where a purchase may not be exempt.

Mr. McPike commented that there can be a situation where two different taxing schemes on the interstate level do not align and cost the Arizona taxpayers more money.

Ms. Comanita responded that the majority of states are destination states.

Mr. McPike stated that at the next meeting he would be interested in seeing what states take that position.

Vince Perez commented that one of the major things that need to be taken from this discussion is that cities have to enact a use tax to capture on materials. Another important piece of information is that 100% of the use tax goes into the general fund.

Elaine Smith from the Department of Revenue stated that use tax is not levied at the county level, so there would be a loss or they would need to be enabled to enact a use tax.

Mr. McPike commented that this conversation illustrates one of the issues that exist from a tax policy perspective. There is a use tax so people are not incentivized to shop out of state when TPT cannot be imposed. He continued that in ideal tax policy would have use tax and TPT at the same rate. There are a lot of jurisdictions where they differ, but from a policy perspective they should not.

Mr. Teposte suggested that the group needs to consider small jurisdictions that do not have a retail base, such as Casa Grande. All of the retailers are located in larger jurisdictions and there would be no tax if the tax is paid at the retail level.

The working group took a ten minute break.

5) Historical Context

Mr. McPike called the meeting back to order at 3:04 p.m.

Barb Dickerson from Deloitte Tax LLP gave a presentation on the historical context of contracting.

a) Working Group Discussion and Public Comment

Representative Gray asked what legally was supposed to be taxed besides materials when the Legislature wanted to tax construction in 1937. He questioned if the intent of the law was for the overhead of a company to be taxed.

Ms. Dickerson responded that it is difficult to say what the intent of the legislation was so long ago.

Representative Gray commented that he is trying to find the rational as to why the system should not go to a point of sale. Some cities may lose money, but contractors are paying the price everyday to go through this process. He suggested that prices may come down, leading to more construction and more jobs in the field.

Ms. Dickerson stated that it was her personal opinion that the state should tax materials and that a minority of states do it the way Arizona does. The system in Arizona leads to uncertainty for contractors and owners. She continued that inside a fixed fee contract there is often an indemnification clause. A contractor will state their amount of tax and the owner will indemnify the contractor. The contractor gets audited and if they do not do everything perfectly then the owner is on the hook as well. Ms. Dickerson reiterated that it was her personal opinion that the current system creates uncertainty at several levels.

6) Revenue Sharing – City and County

Elaine Smith from the Department of Revenue gave a presentation on revenue sharing.

a) Working Group Discussion and Public Comment

Mr. McPike noted that is it important to consider that prime contracting operates differently than the retail classification.

Patrick Irvine from Fennemore Craig asked about the policy of exclusion of use tax.

Ms. Smith responded that she did not find information about that.

Mark Barnes from Barnes and Associates representing the County Supervisors Association of Arizona commented that the issue of where materials originate and the availability of retailers in rural areas is going to be difficult to solve.

Mr. McPike highlighted how complicated the distribution formula is and that there will be gains and losses with change, but that in the end it will make the system easier to understand and administer.

7) Future Working Group Meetings Regarding Contracting

Mr. McPike asked the Task Force members and the public for topics they would like to hear about in future meetings.

a) Working Group Discussion and Public Comment

Linda Stanfield commented that many people are excited about this Task Force because this issue keeps a lot of business owners up at night. A lot of people do not have the money to hire a bookkeeper and do not have the software to tell them that at the city level something is taxed differently than at the state level. She continued that the business owners really need help and that the focus needs to be on simplification. Services are put at risk when one company does their business in one manner and another does business differently. The group needs to look at how to make this system fair.

8) Adjournment

Mr. Hunter adjourned the meeting at 4:25 p.m.